UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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DEXIA SA/NV, DEXIA HOLDINGS, INC.; FSA ASSET MANAGEMENT LLC, and DEXIA CREDIT LOCAL SA,

Plaintiffs,

v. 12 Civ. 4761 (JSR)

BEAR STEARNS & CO., INC.; THE BEAR STEARNS COMPANIES, INC.; BEAR STEARNS ASSET BACKED SECURITIES I, LLC; EMC MORTGAGE, LLC (f/k/a EMC Mortgage Corporation); STRUCTURED ASSET MORTGAGE INVESTMENTS II, INC.; J.P. MORGAN ACCEPTANCE CORPORATION I; J.P. MORGAN MORTGAGE ACQUISITION CORPORATION; J.P. MORGAN SECURITIES, LLC (f/k/a JPMorgan Securities, Inc.); WAMU ASSET ACCEPTANCE CORP.; WAMU CAPITAL CORP.; WAMU MORTGAGE SECURITIES CORP.; JPMORGAN CHASE & CO.; and JPMORGAN CHASE BANK, N.A.,

Defendants.

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New York, N.Y.
September 6, 2012
1:15 p.m.

Before:

HON. JED S. RAKOFF,

District Judge

APPEARANCES

BERNSTEIN LITOWITZ BERGER & GROSSMANN
Attorneys for Plaintiffs
BY: TIMOTHY A. DeLANGE
JEROEN VAN KWAWEGEN

CRAVATH SWAINE & MOORE
Attorneys for Defendants
BY: DANIEL SLIFKIN
YELENA KONANOVA

(Case called)

THE COURT: We have a lot of things to cover, but I think I want to first hear on the motion to remand, and I'm particularly interested in hearing anything anyone wants to say on the Edge Act aspect. Let me hear first from moving counsel.

MR. VAN KWAWEGEN: Thank you, your Honor.

As your Honor is aware, the defendants have raised two grounds to oppose remand. They removed the case based on two grounds. They say that the case is related to 13 bankruptcies and there is also a federal question of jurisdiction under the Edge Act.

Plaintiffs' position is, we don't even have to reach the 13 bankruptcies that the defendants put at issue, your Honor, because of defendants' position with respect to the mandatory abstention statute. The defendants in their papers on page 17 concede that all the elements of the abstention statute, 1334(c)(2), are met except for one, and that one exception is that there is also jurisdiction under the Edge Act and, therefore, this Court should hear this case.

So if the Court finds that there is no Edge Act jurisdiction, abstention is essentially mandatory under the abstention statute.

THE COURT: I know that's your argument. That's why I wanted to hear about the Edge Act.

MR. VAN KWAWEGEN: The Edge Act, as your Honor is

aware, provides federal question of jurisdiction over actions that arise out of international banking transactions. And our position is, there is no federal law at issue in this case, there is no banking law at issue in this case, there is no international transaction at issue in this case and that this is plainly a common law action brought in state court against New York defendants.

So the defendants say that this case is nevertheless governed by the Edge Act because 18 of the 249,902 mortgages in this case were originated in the Virgin Islands. But this is wrong, your Honor.

As your Honor is aware, there are two lines of cases in this district, a line of cases that take a narrow reading of the Edge Act and a line of cases that takes a broader reading of the Edge Act. The narrow reading of the Edge Act I think ultimately can be traced back to the Lazard decision by Judge Wood in 1991 and subsequently followed by Judge Kaplan in BLBNY and Judge Sullivan in City Mortgage, that essentially requires that there is a connection between the federally chartered bank in the case and the underlying international banking transaction. That is clearly not the case here.

The broader reading of the Edge Act I think can be traced back to Lemgruber, that Judge Batts decided, essentially says no, there is no need for a perfect match between the federally chartered bank in the case and the international

banking transaction. But all those cases, Lemgruber, AIG, Lloyd's by Judge Sweet, all find that one of the defendants, whether or not that is a federally chartered bank, engaged in an international banking transaction. And that is not the case here either, your Honor. None of the defendants in this case is alleged to have engaged in any international banking transaction. So even under the broader reading of the Edge Act, we believe that this Court does not have jurisdiction under the Edge Act.

THE COURT: Let me hear from your adversary.

MR. SLIFKIN: Thank you, your Honor.

I think the right place to start is with the wording of the statute itself, 12 U.S.C. Section 632. It says: All suits of a civil nature at common law or inequity to which any corporation organized under the laws of the United States shall be a party, arising out of transactions involving international or foreign banking, and it continues.

So in this case I think you have to look at the two elements of the statute. The first element is, is there any corporation organized under the law of the United States that's a party? The question is absolutely, no question, JP Morgan Chase Bank, NA is a party. Then it says: Does the suit arise out of transactions involving international or foreign banking? We believe it does. There are 18 mortgages originated in the Virgin Islands. That is banking dependency or interior

possession, which is part of the statute, lending practices key to this suit. So on a very simple reading both elements of the statute are met.

Now, the question then arises, as counsel has put it, does the nationally chartered bank, does it have to -- I am now going to quote from Judge Sullivan in City Mortgage, if I may, your Honor, where he said: A nationally chartered bank must have potential liability on claims arising out of the foreign banking transactions.

Now, with respect to Judge Sullivan, that connection is not in the statute.

As your Honor knows, Judge Jones has gone the other way and the Second Circuit has that issue in front of them. But I think we can avoid that issue here. If you look at what Judge Sullivan says, which is, does the nationally chartered bank have potential liability? We argue, well, it does on the way this has been pleaded. The territorial loans here are within an offering called JP ALT 2006(a)(7). In that case the sponsor is JPM Mortgage Acquisition Corp. That, according to the pleadings, is a wholly-owned subsidiary of the NA, national association. And what the complaint says in paragraph 28 is: All allegations against JP Morgan Mortgage are also made against its controlling parent company.

So here plaintiffs seek to hold the NA liable for the actions of its subsidiary with respect to the offering. JP ALT

the 2006(a)(7), that has the residential mortgages in it that arise out of the Virgin Islands. So even under, I think, Judge Sullivan's articulation of the standard, and we understand the Second Circuit may come up with something different, under that articulation, his standard is met. Certainly under Judge Jones' standard of articulation of the standard, which is the statute has no link, again, the elements of the statute are met. That's our submission on that point, your Honor.

THE COURT: Let me hear from plaintiff's counsel in rebuttal.

MR. VAN KWAWEGEN: Your Honor, the difference between Judge Jones' decision in AIG is that there the plaintiffs were seeking defendants, including Countrywide, to hold them liable as originators of mortgages. There is no dispute that the origination of a mortgage is a traditional banking transaction.

Here, that is absolutely not the case. We have not sued any loan originators other than EMC. But as the complaint makes clear, they were not originating their own loans, and certainly there is no indication that they originated any loans in the Virgin Islands.

In this case, unlike a very broad reading of Judge Jones, there is simply no connection, no international banking transaction connecting to any of our defendants, including Chase. If you would take the narrow reading, which we think is the more appropriate reading in the procedural context that we

are now, on removal, for the reasons that Judge Sullivan stated and Judge Briccetti in Weiss v. Hager stated.

But even you if you take the much broader reading of Judge Jones, that is still not covering this case. There is no defendant in this case that is alleged to have engaged in any international banking transaction, and the defendants have not shown that the 18 mortgages that they are pointing to were originated by any defendant in this case. It is true that in that specific offering a JP Morgan sponsored entity ultimately acquired those mortgages, but they have not shown that that is an international banking transaction in and of itself and certainly have not argued that.

THE COURT: I just want to set the stage for the rest of the motions that we are going to hear about in a minute.

As I got into the motion to remand it did seem to me that the whole issue was the Edge Act issue, but it also seemed to me, as I think it's obvious to both sides here, that the case law in this district is not a model of consistency. So I am going to have to sort that out, but I have put aside this weekend to do that. So I will get you on the motion to remand a bottom-line decision by Monday or Tuesday of next week with opinion to follow. I won't have the opinion by then, but I will have reached a conclusion.

The reason I'm mentioning that now, if I do decide to remand I am not going to reach the motion to dismiss. But if I

decide not to remand, then I will reach the motion to dismiss. So I want to hear the oral argument on that now as well.

Why don't we turn to the motion to dismiss and here the movant, of course, is the defendant.

MR. SLIFKIN: Thank you, your Honor.

I am not going to repeat everything in our papers, but there are maybe three points, with the Court's indulgence, that I would like to touch on.

The first being the lack of allegations specific to these offerings, the offerings that have been sued on. The second is the lack of attention in the complaint to the actual disclosures in the documents relating to those specific offerings. And the third is, if I can put it this way, the failure to recognize the very specific elements of a common law fraud claim, as opposed to say a Section 11 claim, which hasn't been brought here, particularly in reliance and causation.

If you look at the first point, the point is, the relationship of the general allegations made in the complaint to the specific offerings here. As your Honor knows, this case involves 51 offerings sold over all of 2006 and half of 2007, approximately, from three separate banks, JP Morgan, Bear Stearns, WAMU, and a bunch of related entities. These are claims for fraud.

So it's not the case the pleading is merely plausible, but the pleading must be with particularity, including as to

why the statements in the 51 offering documents, why they are fraudulent. There are many allegations about problems, I'll put it, of these various entities, about what certain people said, what certain people did, what practices arose. But there is a single overriding flaw. Those are never linked to the specific deals in question. If you look at pages 4 to 11 of plaintiff's opposition to the motion to dismiss --

THE COURT: Let me just pull that up. We didn't bring that up. Go ahead.

MR. SLIFKIN: That's their best shot, essentially, of putting in one place all of the places in the complaint where they say there are allegations supporting the assertion of fraud. And what they then say in argument, and I'll quote from it, it says: Defendants systematically securitized loans that were originated in violation of the stated underwriting guidelines and pointing back to that letter. Now, we submit, that doesn't work. That doesn't work either factually or legally. I want to give you a few examples on the facts as pleaded.

There is a great deal of discussion in the complaint of something called the Clayton report. It's cited repeatedly. We actually attached it to my affidavit, so the Court has it.

It shows that 75 to 80 percent of the loans were absolutely fine under anybody's standard. That alone does not say there is complete abandonment of underwriting guidelines.

That document says 80 percent of them are completely in conformity.

The document continues to show that, depending on the entity we are talking about here, because there are three, between 7 and 14 percent of loans reviewed by Clayton, an independent due diligence factor, were waived in. There is no explanation of what waived in means. For all we know, based on this pleading, they were waived in because whatever technical defect there was in the loan file was remedied. Maybe a HUD-1 statement was missing and it was found. Maybe the borrower hadn't signed some form and he got it signed and then they put it in.

But most importantly, Clayton disavowed in their testimony to Congress or to the government cited in the complaint. They disavowed any knowledge of whether the waived-in loans were actually securitized at all, and the complaint is devoid of any allegation that those waived-in loans were securitized in the offerings that are being sued on.

With your indulgence, I'll give you another example of a document that's featured very prominently in the complaint, something called the Zippy Cheats & Tricks memo. Let me remind the Court essentially what that document says. It concerns a computerized system at JP Morgan for approving mortgages. These are mortgages which have been referred to as stated income, stated asset mortgages. That's to say, all the

borrower needs to do is say, this is my income, these are my assets, not verified. That factor disclosed.

The memo says: Put the numbers into the computerized system, Zippy, and it will say accept or reject. If it says reject, why don't you just change the numbers and see if it then accepts it. That, understandably, is a problem, and if we proceed into discovery, people will learn that the lady who circulated that memo was fired and actions were taken.

What is important in the pleadings stage is that no allegations that people did what the Zippy memo asserts, there is no allegation of how often that was done or by whom, there is no allegation that any such loans were issued because of manipulation of Zippy, if any, were securitized at all, and there is no allegation to suggest the product of the Zippy Cheats & Tricks memo was securitized in these offerings.

I continue, your Honor.

THE COURT: Let me ask you this. Assuming for the sake of argument that the pleadings were deficient in one or another respect of the kind you are now describing, that would be the kind of situation where I would dismiss without prejudice to replead, right?

MR. SLIFKIN: That's correct, your Honor.

That's what you did in the Dexia v. Deutsche Bank case.

THE COURT: I guess one question I have for your

adversary when he stands up, he doesn't agree that the pleadings are deficient. But assuming they are deficient in one or another of these kinds of respects, does he have, based on his investigation or offer that could be the basis for an amended pleading? For example, taking the waiver issue you just mentioned. So that, particularly given the memo, that's suspicious, but in the pleading very little of the details as to why there were waivers has been spelled out, but maybe he has the basis to spell that out. I don't know. That's something for him when he gets up. But go ahead.

MR. SLIFKIN: To finish up on the point about the generality of the allegations and the lack of link, we do recommend both Judge Batts' decision in NovaStar, too, and Judge Castel's decision in Footbridge v. Countrywide which dismissed for just this very reason. And the cases that plaintiffs cite contrary to that really do highlight the distinction I've been making. If you look at the MBIA decision, your Honor, in the New York Appellate Division, there is a specific listing of more than 4,000 loans. The plaintiffs say, we reviewed these loans that were securitized and we know they are defective based upon the guideline. Or in the Dodona case, which was Judge Marrero's case, regarding a securitization by Goldman Sachs, there was very specific evidence that the Goldman Sachs regarded these offerings as containing defective loans, e-mails from Goldman Sachs.

Nothing like that here, your Honor.

But even beyond that, even beyond that point, your Honor, there is the point that plaintiffs seem to disregard the disclosures that were made in the documents at issue. Obviously, 51, the numerous tranches, even within those 51 offerings. But to sort of summarize, since we can't possibly go through all of them, when there is a discussion of the underwriting guidelines, there is also discussion that exceptions are made. There is also a discussion that the underwriting guidelines are less stringent than agency, the federal agency guidelines.

There is also a discussion about that repurchase is possible because some of the loans might be defective. So it is not the case that there was a representation that every single loan met a stringent guideline, because these guidelines aren't that stringent. The guidelines are actually available to the purchaser. There are exceptions. And we might be repurchasing some of these precisely because they are defective.

The same could be said about the due diligence allegations. There is a disclosure about due diligence. It says it's varied. It says, there is a sampling basis. So the allegation, which it was misrepresented was due diligence because you don't use a sample, it says that in the offering documents. I can go on to talk about occupancy, simply

information from borrowers, appraisals. That's the information from the appraiser. There is no allegation that that's false.

Credit ratings. There is no question that the credit ratings of the underlying borrowers are disclosed, but there is no allegation that they are false. The allegation is, well, I don't think they are really that useful. That's not the standard. They have to be false, your Honor, and there is no allegation that they are false.

If I might then turn to the last two points --

THE COURT: Yes.

MR. SLIFKIN: -- that I wanted to talk about. In the context of a common law fraud suit, you have to look at every single element. And there are two I want to focus on. The first is reliance. This is not fraud on the market reliance. This is eyeball reliance. The plaintiffs have to allege, with respect to each of the statements they are seeking to sue on as being false or misleading, as being fraudulent, that not only did they look at that statement, they actually read that statement, but they relied on that statement in making their purchase decision.

Here, there is absolutely no allegations that that was done, none. Certainly there are no allegations about how plaintiffs then did their own independent due diligence, which, again, is an aspect of reasonable reliance. But they fail even at the threshold of actual reliance.

Finally, if I may say a word about causation and damages, these securities are similar to bonds in that there is a payment stream over time and of interest and principal and a repayment to the end of a period because, as your Honor knows, there are mortgages on the line. That's how mortgages work.

Plaintiffs have not alleged that they missed any principal or interest payments. There is no allegation they didn't get what they bargained for in purchasing these securities. The allegation, however, is that there was a diminution in value of the bond. If you look at the prospectuses, it's explicit, there is no assurance that there will be any second remarket for these securities. So to say, well, I didn't get the value I was promised, you weren't promised any value in the sense there being a second remarket value. You were promised an income payment stream and you have not alleged that you didn't get that, which we think is really a complete failure to plead causation, again, a necessary element of the underlying causes of action.

Thank you, your Honor.

THE COURT: Thank you very much. Let me hear from plaintiff's counsel.

MR. DeLANGE: Thank you, your Honor, Timothy DeLange, Bernstein Litowitz Berger & Grossmann on behalf of the plaintiffs.

I am going to respond to each one of the points that

Mr. Slifkin made, but I want to start with the specific question that you had highlighted that would be addressed to me.

The short answer is, yes, if the Court found for whatever reason that the pleadings were deficient, we could add additional facts and additional allegations specifically with respect to the waiver point that counsel was arguing and the Court asked a question about.

If you look at the Clayton report, defendants' interpretation of it is wrong. There is an initial rejection rate. Clayton reviews a sample of loans. And based on that review they determine, do these loans meet the guidelines or do they not? And there is numbers in there that reflect the percentage that do not. Defendants then have discussions with Clayton. In fact, they tried to get Clayton to reverse those decisions that certain loans violated those guidelines. Ultimately, there is a final rejection rate and that final rejection rate is also reflected in the exhibit that was provided to your Honor.

There is then a waiver right. That waiver rate is the percentage of loans that defendants disregarded Clayton's conclusions, disregarded them. They were told they violated the guidelines. They had the opportunity to discuss that with Clayton, and they decided they are going to ignore it and they waived.

Now, Clayton, it is correct in their testimony they disavowed knowledge as to whether or not the loans that were waived in ultimately ended up in a securitization. Their job was finished at that point. They provided the due diligence to these defendants and other defendants in this arena for their purchase of loans. But, as we know, and as everyone knows, defendants were purchasing these loans not to hold for investment, they were purchasing them to sell. And it is not a reasonable inference that loans that were waived in and the defendants bought anyway did not end up in securitizations, and that's an inference that the defendants would like the Court to reach that is not reasonable. That's the quick response to your question.

I'll now address each of the three points that counsel raised. I'll start with what he characterizes as a lack of allegations specific to the offerings. That's just flatly incorrect. We have tables and charts showing that the performance of each of these offerings was dismal. As of the filing of the complaint, 40 percent on average, 40 percent of the loans in these offerings were delinquent. That's a terrible performance.

We also allege the downgrades. When my client bought these, every single one of these investments was a triple A rated security, supposedly the safest investment you could invest in. Now, virtually every single one of them has been

downgraded, virtually every single one of them have been downgraded to junk.

You take those allegations along with what this complaint details. And what that complaint details, and defendants don't deny and they don't challenge, defendants engaged in a systemic fraud of their mortgage securitization system. The entire system was fraudulent. It was based on volume and volume alone. And they knowingly took steps to disregard due diligence. They knowingly waived in loans that they were told violated the guidelines. They knowingly securitized loans that had been originated pursuant to fraud.

In the case of WAMU, there is a credit risk memo identifying that they have no credit risk procedures to control against selling fraudulent loans to investors. That's what their complaint details. Defendants are attempting to focus on one aspect. You don't say that one loan in these 51 offerings was pursuant to fraud or was pursuant to a waive in from the Clayton report. Their entire system was fraudulent, including these 51 offerings.

These 51 offerings are in the complaint because that's what my client purchased. But the other offerings that the defendants engaged in during this time period suffered from the same problems that are detailed in this complaint and it's detailed from the Clayton report showing that they were told these loans violated your underwriting guidelines and they

chose to waive them in any way. It's detailed from testimony from government investigations of high-level employees and defendants testifying that, yes, we were engaged in volume, volume only. We put pressure on people to get loans in. We reduced the due diligence.

Bear Stearns told their due diligence vendor, in addition to not doing due diligence on occupancy status, in addition to not doing due diligence on appraisals, we don't want you to go out and verify employment. They were limiting their due diligence. In the case of WAMU, same situation. There was a high-risk lending strategy internally that the bank employed. It was to go out and get as many loans as possible.

THE COURT: Let me ask you this. I am going to depart from the facts of this case and put this into totally hypothetical terms.

Supposing some financial institution engaged in pervasive fraudulent tactics with respect to the securitization and subsequent sale of particular securities, but the particular ten securities that a hypothetical plaintiff bought were not subject to those problems. They were legitimate. They were not misrepresented. Everything was fine as to them, even though there were frauds going on, but it didn't affect them. And it was the state, New York State fraud claim, not a federal claim. So there wouldn't be a claim in that situation, right? The fact that there was pervasive fraud affecting, in

my hypothetical, thousands of other securities wouldn't matter if there was no fraud with respect to the lucky ten that this hypothetical plaintiff had purchased.

So what I'm getting at is, don't you still have to show something much more specific about the particular securities that are involved here in order to make out a state law fraud claim?

MR. DeLANGE: The answer is yes, and we have done that. Under your hypothetical, those ten securities that were not infected with the systemwide fraud would perform as expected and they would continue to have their triple A ratings. Maybe they would be downgraded to double A.

THE COURT: They might be downgraded because of changes in the economy, all sorts of extrinsic factors.

MR. DeLANGE: That's certainly possible, and potentially at trial defendants could offer evidence that that's the case.

But looking at the pleading stage, and have plaintiffs, under Rule 9(b), pled the who, what, when, where, and how, and you have this systemic fraud that infects the entire business. This is how they did business and they knowingly did the business this way. Then you have 51 offerings that suffered from dismal performance, dismal delinquency rates, and they have all been downgraded, virtually now all of them now junk. That tells you the reasonable

inference is, that systemic fraud included these 51 offerings. They were not the ten offerings that, in the Court's hypothetical, continued to perform well and were infected with the fraud.

THE COURT: You had other things you wanted to address and I want to hear all those. I am particularly interested in hearing what you want to say on the issue of reliance, given the relatively sophisticated nature of your claims.

MR. DeLANGE: I will start with reliance, your Honor, and I'll go back to the other points I was going to make.

Defendants mischaracterized the complaint. They allege that we don't have any allegations of reliance. I feel they are moving to dismiss another complaint in an RMBS case because our complaint is replete with allegations of reliance and it details that the purchaser here, which was FSAM, there is an entire paragraph, two paragraphs, 287 to 288 in the complaint, that focus on what FSAM reviewed and what they had to do before they could purchase these types of securities. They had underwriting guidelines that they had to follow. And pursuant to those guidelines, they had to analyze the credit quality and credit characteristics of whatever security they were buying and that's what they did here. FSAM was the purchaser and we specifically allege the detail of what they did, the information they relied on.

In addition, after each one of the false statements

regarding -- again, the false statements all detail and relate directly to key metrics in a mortgage-backed security. A key metric that shows the quality of the underlying collateral, because that's what you are buying and that's what you look at, is, is this underlying collateral the quality that they are representing to me? That's what is important. And the key metrics that were misrepresented, the plaintiff, who made the purchases, FSAM, relied on that. We make that specific allegation. The notion that we don't make any allegation in that respect at all is contradicted by the details in the complaint.

With respect to the argument that plaintiff is a sophisticated investor, they are a sophisticated investor and they did their due diligence. They looked at these metrics that were provided to them. They analyzed these metrics in accordance with their underwriting guidelines.

What they didn't have and couldn't have had that defendants somehow want to argue that they should have went and found is facts that defendants were waiving in half of the loans that Clayton told them violated the guidelines. There is no way my client could have uncovered that. There is no way my client could have uncovered the fact that Bear Stearns gave directives to limit due diligence. There is no way my client could have uncovered the fact that Washington Mutual's subsidiary affiliate, Long Beach Mortgage, was engaged in

rampant fraud in 2005. WAMU uncovered it and did nothing about it and then admitted in a memo that they didn't have appropriate procedures to keep fraudulent loans out of securitizations to investors. Those details, that information was not available. There is not a case defendants can cite to that put the burden on even a sophisticated plaintiff to uncover the details of the fraud here.

I would like to take a quick step back to the second point that defense counsel made, which was the disclosures in the documents. And this really falls from the argument that I've been making thus far. The documents disclose that there may be exceptions when there is appropriate compensating factors. I have read through the documents. I've read through the prospectus supplements. Nowhere does it say that defendants are going to disregard and waive in half of the loans that our due diligence vendor tells us violates the guidelines. That's not disclosed. Nor is it disclosed that they are going to include fraudulent loans. The details of the allegations of the systemic fraud were not disclosed, and we won't find specific disclosures on any of that anywhere in the offering documents.

The last point that counsel made -- I want to back up. One point I want to correct that counsel made. Counsel made the statement that there is no dispute that 75 to 80 percent of the loans in these pools were good or okay, I think was the

statement. That's wrong. Clayton only sampled and defendants only sampled a certain percentage of the loans. And they got the information from Clayton and their other due diligence vendors based on that sample.

What defendants never did, and this is not disputed, is they never took the results of that sampling and extrapolated it to the remaining 80 percent, 90 percent of the pool that they never even looked at. So you have a small set of samples that they looked at, found violations, waived them in any way, and then they disregarded those results, did nothing with them, and took the remaining 90 percent of the pool, put it together, and sold it to the investors. That's what happened. A statement that 75 or 80 percent were okay is inaccurate.

The last point --

THE COURT: Is there any suggestion that the sampling was anything other than a reasonable cross-section?

MR. DeLANGE: We do not make an allegation that the sampling was intentionally chosen for certain results. That allegation is not made in our complaint. We don't even make an allegation that counsel had mentioned we allege that they didn't conduct enough due diligence, but they disclosed they were only going to sample a certain amount. We know that. We don't allege that their disclosure of the fact that they are going to sample was false. The problem was they got results.

Why would you sample if you are not going to use the results? They sample and then take that small sample --

THE COURT: I understand that. But then why isn't it fair for your adversary to extrapolate from the sample, even if the sampler themselves do not? If it's a reasonable cross-section and a statistically sufficiently large sample that one can infer that it's representative of the whole, then you can reasonably infer about the whole from it, yes?

MR. DeLANGE: The counter is true as well, which is I can extrapolate from that sample and show that 25 to 30 percent of the entire pool violated the underwriting --

THE COURT: You, in effect, have been arguing that.

MR. DeLANGE: Correct.

THE COURT: I do think it cuts both ways is my point.

MR. DeLANGE: I agree with that, your Honor. The way the RMBS are structured, that is critical. If there is 20 percent of the pool that violates these guidelines and is misrepresented to investors, that infects the overall performance of the tranches and the waterfall.

Finally, with respect to damages and causation, again, I think defendants are moving to dismiss another complaint. They argue that we are alleging a diminution in value based on delinquencies and downgrades. That's not whether the complaint alleges. And the case law in New York State court is pretty clear that the damages on these claims is the difference

between what you pay and the value of what you got at the time of purchase, and that's what we allege. We allege that what we paid was more than what we got, more than the value of these certificates measured at the time of purchase. And the reason for that is because, going back to the sample, 20 percent of these loans violated guidelines. There was a higher risk they were going to default. There is going to be less money coming through the waterfall. You are buying a junk bond, but you are paying triple A prices for it. That's the damages we allege and we clearly allege the causation, which is based on all of this systemic fraud, I'm buying something that's worth less than what I am paying for it.

Unless the Court has additional questions, I have nothing further.

THE COURT: Very good.

I'll hear from your adversary in rebuttal. Thank you.

MR. SLIFKIN: I'll be brief. Thank you, your Honor.

Let me hit on a couple of points. The allegation, principal allegation here is when it was represented that there was -- the underwriting guidelines that were generally followed, with exceptions, because that's stated, and with repurchase rights, because that's stated, that was untrue. So the allegation is not that everything was perfect, because there was disclosure that everything wasn't perfect. Lots of human intervention here. The allegation, there was a wholesale

abandonment, systematic disregard of the underwriting guidelines.

What has counsel presented? He says, take a look at the Clayton report. Take a look at the Clayton report. Slifkin affidavit, Exhibit 1, page 2. It says there is 72,000 loans reviewed. It says 60,000 of those loans were accepted as being fine. 60,000 out of 72 were absolutely fine. It says. 6,800 out of the 72 were rejected because they were defective. And 4,923, 7 percent, 7 percent of the total, were waived in with no explanation of what waiver means.

Your Honor, that is not abandonment of the guidelines. That is application of the guidelines. When something like over 80 percent of the loans are found to be acceptable, I don't see how that can be used as the basis of a pleading that the guidelines were abandoned. And 6,000, a little less than 10 percent, were rejected. That's not abandonment of the guidelines. That's an application of the guidelines.

Counsel then said, we know, in addressing my point, you have no idea if these loans constitute, these waivers constitute, and you have no idea, I have not alleged it was securitized here. The performance has been dismal. So what? Remember, we are dealing with pleading with specificity, not mere plausible inference. How would a dismal performance in the economy that we have just been through and housing market we have been through show you that the underwriting guidelines

were abandoned?

Then he says, well, stuff got downgraded by the rating agencies. He said, well, if everything had been fine, okay, we would expect a downgrade, there will still be an investment grade. Actually, one of the offerings is still investment grade because of seniority of the tranche that they purchased.

Your Honor, that is a specific disclosure about downgrades, about rating agencies and downgrades and it says: We get these ratings from the agencies. There is no allegation that we inaccurately stated what the rating agencies gave us and it says, this may be downgraded. So what happened is what they were warned of.

THE COURT: I am not sure I follow that point. Their argument is not that the possibility of downgrade wasn't disclosed. Their argument is that the severe nature of the downgrade here raises a plausible inference that it was because they were really junk masquerading at triple A securities.

And your first argument is, well, downgrading can occur, especially the kind we have been through for a hundred different reasons, so it's not, in your view, plausible to assume that the mere fact of downgrading shows that they were junk. I understand that argument. But I don't think it's a question of disclosure. They are not arguing, at least the argument they were making this morning was not that the possibility of downgrading had not been disclosed. Their

argument was that the severe nature of the downgrading was circumstantial evidence supportive, corroborative of their allegations of fraud.

MR. SLIFKIN: My only point, your Honor, was that if you take the totality of the allegations and the statements, there is no allegation that the original rating was inaccurately conveyed to the investor. And my only point is, all that has happened here was they say there is powerful evidence of fraud is what was actually identified as a possibility in the document at the time of purchase.

THE COURT: I hear your point. I actually think the downgrade, I am not sure how I infer this, but it seems to me that it arguably also is relevant to your argument about reliance. If the rating agencies, with at least this much expertise as the plaintiffs here could be, according to plaintiffs' allegations, inferentially, fooled, because there are facts that they couldn't find out that no person could find out through due diligence and, therefore, they gave it a much higher rating than it deserved if they know all the facts, isn't that circumstantial evidence supporting their argument that the mere fact that their clients were highly sophisticated people doesn't mean that they weren't defrauded or didn't have reasonable reliance because there is only so much you can find out through due diligence? So what about that?

MR. SLIFKIN: I think there are two points there, your

Honor. There is the actual reliance point and the reasonable reliance point, and I think they have to be taken together. The reason I say that is because, what they are saying is, here is a statement, here is a representation about adherence to underwriting guidelines. They are saying that was false and I reasonably relied upon that. I don't think you can take what the rating agencies did and use that in any way to support what their allegation should be, which is, I actually eyeball relied justifiably on this statement about underwriting guidelines because we don't know that that factored at all into the rating agency's decision. That could be on completely different grounds. All we know is the rating agencies have their own criteria and they did what they did and that was reported.

THE COURT: It doesn't go to actual reliance. But doesn't it go to your argument about reasonable reliance? That is to say, I thought your argument in part, not by any means exclusively, but in part was that sophisticated plaintiffs like the plaintiffs here could have, through due diligence, found out everything relevant to these securities so they don't have a basis to sue? And the argument then I'm throwing out, and I want to stress I'm just throwing it out without saying whether it's a good argument or a bad argument, is that if the rating agencies couldn't figure it out, why should these plaintiffs be able to figure it out, assuming arguendo there is anything to figure out?

MR. SLIFKIN: The reason I said justifiability of reliance has to be looked at in the context of the actual reliance is because what your Honor just said, your Honor. You said, the rating agencies couldn't figure that out and the question is, what is the it? The it is the false statements.

So let's talk about underwriting guidelines. As we point out in our opening paper, pages 9 to 10, by the time these plaintiffs are buying these securities, 2006 and as late as August 2007, you look in the media. There is all this information in the public domain about underwriting guidelines, the originators going bankrupt and all these problems. That goes directly to the statement about underwriting guidelines and adherence to those guidelines, whereas the rating agency goes to -- I don't know what they go to. It's the rating agency's criteria. There is no allegation the underwriting guidelines have anything to do with that.

THE COURT: I hear what you are saying. I understand.

MR. SLIFKIN: Thank you, your Honor.

THE COURT: Thank you very much. Let me hear if there is anything further on this issue with plaintiff. I sort of had the sense that you wanted a surrebuttal here.

MR. DeLANGE: Thank you, your Honor. I think my facial expressions may have given that away. I'll be very brief.

The point the Court raises I think is a very valid

point. As an investor in the market you have the rating agencies, which are provided information directly from the defendants and asked to provide their opinion, their rating on the quality of the underlying collateral and the quality, the credit quality of the security, and they are providing triple A ratings.

In addition to the other information that is included in the prospectus supplements, you have a triple A rating from the rating agencies and there is news articles and testimony that has now come out, the ratings, the triple A rating, that was critical to defendants. They admitted it in testimony. They needed that to go out and market it to investors.

But I want to point out --

THE COURT: To put it a different way, and I will let defense counsel have the final word, this is one aspect. I don't want to dwell on it unnecessarily, but you can be reading all the news articles you want. But if you saw that the rating agencies, with access well beyond what a newspaper reporter might have, is still saying triple A, why isn't that a basis for even a sophisticated investor to rely? Say there is nothing here that requires further -- we have seen these articles that the underwriting guidelines may not be really followed, but, gee, they are still getting a triple A rating from the people who looked into it. That's not the only thing they have to do, but it certainly seems to me that even a

sophisticated investor, one could plausibly maintain, to put it in pleading language, that even a sophisticated investor, under those circumstances, could say, well, if the rating agencies, notwithstanding those newspaper articles, are still giving it triple A, that's something I can rely on. But I will hear from your adversary on that.

MR. DeLANGE: That hypothetical I agree with, your Honor.

THE COURT: I thought you might. When the Court gives you a softball you know you should hit it out of the ballpark.

MR. DeLANGE: You don't know when the next one is going to come, so you have to take advantage of it.

THE COURT: Is there anything further you wanted to add?

MR. DeLANGE: One additional point that I wanted to make. One is on this reliance point. Defendants are sort of caught in a catch 22 and their brief highlights this. They argue that the sophisticated plaintiff such as my client should have gone out and done its due diligence and uncovered this fraud before it invested. And what do they refer to? They refer to monthly remittance reports, publicly-available information regarding RMBS, publicly-available information regarding the originators, data provided by third-party vendors. And then they turn around and they say, well, you have all that in your complaint, but that's not sufficient to

allege fraud. If it's not sufficient to allege fraud, and, by the way, we have a lot more than what they highlight there, how can they put a sophisticated investor and say you can't rely because you should have figured this out?

The last point I want to leave the Court with is, you asked Mr. Slifkin what the it was and his response was, underwriting guidelines. And that's too narrow of a reading of the complaint in this case. The it is the quality of the underlying collateral. That's what was misrepresented. That's what the case was about. And it is what the complaint details.

Thank you, your Honor.

THE COURT: Thank you very much.

Let me hear in still further rebuttal.

MR. SLIFKIN: Let me address the triple A, your Honor. I think your hypothetical was really very good.

Plaintiffs have to show reliance on the statements they allege to be misleading. If what they are saying is, well, what we really did was rely on the triple A rating, that doesn't tell you that they relied upon the statements alleged to be misleading. It tells you they relied on something else.

Now, you might say to yourself, well, but what do the rating agencies base their triple A rating on? We don't know. That's not pleaded. Having said, I relied on triple A rating, that's why I really bought it, I don't know what that was based on. Hypothetically, one can assume it might be based on the

fact that the rating agencies, with their experience, said, look at the structuring of this offering, look at the tranches that I'm rating triple A. That would have to be a 30, 40 percent decline in the housing prices for these to be anything but golden. That's unprecedented. That's never going to happen.

Because the chairman of the Federal Reserve, Mr. Greenspan, said, the housing prices always go up. If that's the basis, they just happen to be wrong. That doesn't tell you anything about whether they were justifiably relying upon the alleged misrepresentations.

If I may just respond to the last point that counsel made, their pleading is, there was all this stuff in the public domain and that's good enough to plead fraud. We disagree. We think they fail at that threshold point. If they get past it, if they get past the pleading of falsity, then they also have to plead justifiable reliance. And given how all that stuff was in the public domain, then they fail in the hurdle of justifiable reliance, and I think that's the way logically these arguments ought to be analyzed. Thank you, your Honor.

THE COURT: Thank you very much.

Just to continue with the schedule, if in the bottom line that I give you no later than next Tuesday I do not remand, I will give you a bottom line on the motion to dismiss no later than the end of September. Again, it may well be with

an opinion to follow, but at least you'll know what you need to know in terms of moving forward.

That leaves us with one last thing which are the discovery issues that you raised and I put off to today. And I think with apologies, in light of the hour and the fact that my poor law clerk hasn't had her lunch yet, what I am going to do is the following. If I remand, then these I think are appropriately handled by the state court. If I do not remand, then you should jointly call on Wednesday and I will hear you on it at that time, and my apologies for not being able to reach you today. But I assume that between now and Wednesday you can survive without rulings on those requests.

MR. DeLANGE: Your Honor, just one question on Wednesday. Is there a particular time?

THE COURT: Why don't we set a time. Let's look at our calendar.

THE DEPUTY CLERK: Wednesday, the 12th.

THE COURT: Why don't we say 3:30 on Wednesday.

MR. DeLANGE: Thank you, your Honor.

THE COURT: Very good.

MR. SLIFKIN: May I add one additional point, your Honor?

THE COURT: Yes.

MR. SLIFKIN: If we get to Wednesday, the question of the discovery requests and the responses, you are being given

the written responses. Since then there has been a lot of discussion and JP Morgan has offered to provide documents that it hadn't initially, that it initially objected to. You don't have that. I don't know if you want that to make this productive, were this to go ahead, or I can do it orally.

THE COURT: Why don't we do it orally. I'm very glad to hear that, that they resolved large parts of it. We will just do it orally.

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